Before the
UNITED STATES COPYRIGHT ROYALTY JUDGES
Library of Congress
Washington, D.C.

In re	**DOCKET NO. 14-CRB-0001-WR (2016-2020)**
DETERMINATION OF ROYALTY RATES AND TERMS FOR EPHEMERAL RECORDING AND DIGITAL PERFORMANCE OF SOUND RECORDINGS (*WEB IV*)	

NATIONAL ASSOCIATION OF BROADCASTERS' OPPOSITION TO SOUNDEXCHANGE'S MOTION TO STRIKE SECTION III OF THE WRITTEN DIRECT TESTIMONY OF PROFESSOR MICHAEL KATZ

INTRODUCTION AND SUMMARY

SoundExchange's Motion To Strike Section III of the written direct testimony of Professor Michael Katz, the lead economic expert for the National Association of Broadcasters, has no proper basis and should be denied.

SoundExchange complains that the six paragraphs that compose Section III of Professor Katz's written direct testimony represent inadmissible testimony concerning the law and should therefore be excluded. As reflected in his CV (Ex. 1 hereto), however, Professor Katz is an economist and professor of economics, not a lawyer or a law professor. As such, his testimony is presented from the perspective of an economist, albeit one who has extraordinary expertise in areas such as competition, antitrust, and business regulation, where law and economics are closely intertwined. Based on his experience and training, Professor Katz unquestionably has non-legal expertise that bears on the issues before the Judges; SoundExchange does not and cannot contend otherwise.

Notably, despite moving to strike Section III of Professor Katz's testimony in its entirety, SoundExchange neglects to quote that testimony or even attach it to the motion; instead, it presents only isolated snippets that can be made to sound "legal." Considered in context, however, Professor Katz's testimony in Section III is economic in nature and explains how an economist would construe the prices paid by willing buyers and willing sellers based on economics and competitive market principles. Written Direct Test. of Michael L. Katz (Oct. 7, 2014) (Ex. 2 hereto). Professor Katz concludes the challenged section by observing that:

> "[t]he creation of a rate-determination process and its willing-buyer/willing-seller standard can best be reconciled with economic principles and common sense by interpreting willing buyers as those who have meaningful choices among competing sellers, rather than facing a single, all-or-nothing offer from a monopolist.

Id. ¶ 17 (emphasis added). Professor Katz's quotation of the standard to provide context for his testimony – *i.e.*, "rates and terms that most clearly represent the rates and terms that would have been negotiated in the marketplace between a willing buyer and a willing seller" (*id.* ¶ 13) – and his observation that the Librarian's conclusion was consistent with his (*id.* ¶ 17) do not alter the fundamentally economic nature of his analysis, which is entirely proper and consistent with other economic testimony commonly presented and accepted in rate-setting proceedings.

SoundExchange relies primarily upon federal court cases involving juries in which the court was properly mindful of the potential for confusion if a jury received conflicting legal instruction from two sources. There is no risk of such confusion here; accordingly, courts repeatedly have recognized that the "gatekeeper" function is less crucial when a case is being tried to the court rather than to a jury. Moreover, because of the particular nature of the issues before the Judges, there is a long history of the parties presenting economic testimony related to the willing buyer/willing seller standard, as Professor Katz does in Section III of his testimony. Indeed, one of the challenged paragraphs in Professor Katz's testimony (*id.* ¶ 17 nn.6-7) cites

and quotes the testimony of SoundExchange's experts in two prior proceedings before the Copyright Royalty Judges. SoundExchange does not explain how the cited testimony from its experts could be proper yet the testimony by Professor Katz on the same point is supposedly inadmissible. SoundExchange's presentation of such testimony is not limited to the past; its current economic witnesses, Daniel Rubinfeld and Eric Talley, present testimony that is every bit as "legal" as Section III of Professor Katz's testimony allegedly is. Finally, the examples that SoundExchange cites where the Judges excluded testimony on the basis of being unduly legal – most notably, testimony offered by a law professor concerning legal history – confirm that even the single challenged section of Professor Katz's testimony easily falls on the proper side of the divide.

For all of these reasons, SoundExchange's motion should be denied.

ARGUMENT

I. Professor Katz Does Not Offer Inadmissible Legal Conclusions.

Rule 702 of the Federal Rules of Evidence provides that "[i]f scientific, technical other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education, may testify thereto in the form of an opinion or otherwise." *See U.S. ex rel. Miller v. Bill Harbert Int'l Constr., Inc.*, 608 F.3d 871, 894 (D.C. Cir. 2010) (*citing* Fed. R. Evid. 702).[1] "In general, Rule 702 has been interpreted to favor admissibility." *Khairkhwa v. Obama*, 793 F. Supp. 2d 1, 10 (D.D.C. 2011), *aff'd*, 703 F.3d 547 (D.C. Cir. 2012) (citing *Daubert v. Merrell*

[1] The Judges have held that they will "interpret the Rules and Regulations in the manner most consistent with the Federal Rules of Civil Procedure (F.R. Civ. P.) and the Federal Rules of Evidence (FRE)." *See* Order re Joint Mot. To Clarify Regulations, Docket No. 2006-1 CRB DSTRA, at 1 (June 14, 2007).

Dow Pharms., Inc., 509 U.S. 579, 587 (1993) and Fed. R. Evid. 702 Advisory Committee's Note (2000) ("A review of the caselaw after *Daubert* shows that the rejection of expert testimony is the exception rather than the rule.")).

While the court's role as a "gatekeeper" with respect to expert witnesses can be critical for a jury trial, "the importance of the trial court's gatekeeper role is significantly diminished in bench trials . . . because, there being no jury, there is no risk of tainting the trial by exposing a jury to unreliable evidence." *United States v. H & R Block, Inc.*, 831 F. Supp. 2d 27, 30 (D.D.C. 2011), *aff'd*, 304 Fed. App'x. 674 (10th Cir. 2008) (*citing Whitehouse Hotel Ltd. P'ship v. Comm'r of Internal Revenue*, 615 F.3d 321, 330 (5th Cir. 2010)); *see also Bevill Co. v. Sprint/United Mgmt. Co.*, No. 01-2524-CM, 2007 WL 1266675, at *2 (D. Kan. Apr. 30, 2007), *aff'd*, 304 F. App'x 674 (10th Cir. 2008) ("In a bench trial setting, it is appropriate for the court to allow the expert to testify, and later make determinations about the admissibility, weight, and credibility of the expert's testimony.").

Even in non-ratemaking proceedings, an expert's testimony may be admissible if it discusses legal standards, provided that the opinion is not "solely legal in nature or consisting solely of legal conclusions." *See Paine ex rel. Eilman v. Johnson*, No. 06 C 3173, 2010 WL 785384, at *3 (N.D. Ill. Feb. 26, 2010) (emphasis added). As one court recently noted, there is a difference "between an expert witness who improperly invades the court's authority by discoursing broadly over the entire range of the applicable law and the permissible, helpful expert testimony that direct[s] the jury's understanding of the legal standards upon which their verdict must be based." *Fid. Nat'l Fin., Inc. v. Nat'l Union Fire Ins. Co. of Pittsburg, PA*, No. 09-CV-140-GPC-KSC, 2014 WL 1286392, at *8 (S.D. Cal. Mar. 28, 2014) (quotation marks omitted).

Pursuant to these principles, Section III of Professor Katz's written direct testimony is admissible. It provides an economic framework for the willing buyer/willing seller standard, not a legal opinion. Drawing on his training and experience as an economist,[2] Professor Katz has conducted a detailed economic analysis of critical issues in the current proceeding, precisely as requested by the Judges in the Web IV Commencement Notice, which provides that "the Judges are best served if the participants, their economic witnesses, and their counsel craft arguments in a manner that assists the Judges in identifying and applying the optimal economic analysis when establishing rates and terms pursuant to the Act." *See Determination of Royalty Rates for Digital Performance in Sound Recordings and Ephemeral Recordings (Web IV): Notice Announcing Commencement of Proceeding with Request for Petitions To Participate*, 79 Fed. Reg. 412, 413 (Jan. 3, 2014) (emphasis added). Professor Katz discusses economic principles that should guide application of the willing buyer/willing seller standard and applies that discussion to provide context for his criticisms of the SoundExchange's favored interactive benchmark.

Professor Katz makes economic arguments based on economic concepts – not legal arguments – in Section III of his written direct testimony. Specifically, Professor Katz testifies that, from the perspective of economics, the willing buyer/willing seller standard is most appropriately understood as asking what would happen in an effectively competitive market in the absence of the statutory licensing regime. *See* Ex. 2 ¶ 16. Otherwise, from the perspective of economics, "any price above marginal cost could be considered to be [a] price at which a seller would be willing to transact," and "even a monopolist charging the monopoly price would

[2] Professor Katz is a distinguished economist who holds the Sarin Chair in Strategy and Leadership at the University of California at Berkeley. He also holds a joint appointment at the Haas School of Business Administration and the Department of Economics at Berkeley. He specializes in the economics of industrial organizations, which includes the study of competition and pricing, as well as antitrust and regulatory policy. *See* Ex. 1; *see also* Ex. 2 ¶¶ 7-12.

constitute a willing seller that faces willing buyers." *Id.* ¶ 15. He concludes that "[t]he creation of a rate-determination process and its willing-buyer/willing-seller standard can best be reconciled with economic principles and common sense by interpreting willing buyers as those who have meaningful choices among competing sellers, rather than facing a single, all-or-nothing offer from a monopolist" or sellers with equivalent market power. *Id.* ¶ 17. The concepts of exchange between buyers and sellers, market power, monopoly, and competition all are fundamental economic concepts. Indeed, as evidenced by the fact that the vast majority of his testimony is not challenged, the thrust of the testimony is directed to the application of economic principles to those benchmarks, not the legal standards themselves. *Fid. Nat'l Fin*, 2014 WL 1286392 at *9 ("Amoruso couched his opinion in legal terms, but he may refer to the law in expressing his opinion so as to assist the jury understand the facts. While two of Amoruso's headings convey strong statements of how to apply the law to the facts (*e.g.*, 'NU acted in bad faith' and 'acted maliciously'), the body of his report gives concrete information about industry customs to analyze the facts that support those opinions.") (citations and quotation marks omitted) (emphasis in original).

The cases cited by SoundExchange do not suggest a contrary conclusion. SoundExchange's reliance on *United States v. El-Mezain*, 664 F.3d 467 (5th Cir. 2011), is misguided because that case involved the testimony of lay witnesses in a jury trial, not an expert witness such as Professor Katz in a rate-setting case. Similarly, SoundExchange's attempted comparison of the testimony of Professor Katz to the previously excluded testimony of Professor William Fisher and Dr. George Ford is unavailing. In its argument to exclude Professor Fisher's testimony, SoundExchange stated that "Your Honor, Professor Fisher is a law professor. He's not an economist." Motion to Strike Testimony of Michael Herring and Michael Katz, Ex. E at

5:11 (Apr. 1, 2015). In contrast, Professor Katz is an economist, not a lawyer or a law professor. Similarly, the excluded testimony of Dr. Ford pertained to "legislative history" and "relevant decisions applying and/or interpreting" the statute. *Id.* Ex. C at 7. In both, pure legal analysis was pervasive. In contrast, Section III of Professor Katz's testimony is explicitly focused on economics.

II. SoundExchange's Own Witnesses Have Consistently Offered Testimony Regarding the Rate-Setting Standards Under Section 114.

SoundExchange's position that Section III of Professor Katz's testimony should be stricken is irreconcilable with the testimony that has consistently been offered by SoundExchange in proceedings before the Judges. In *Web II*, for example, SoundExchange's expert economist, Professor Michael Pelcovits, offered his opinion as to how the statute should be interpreted: "the willing buyer/willing seller standard can and should be interpreted broadly enough to encompass these two other factors [i.e., substitution/promotion effects on phonorecords, and relative roles of the parties] and any other consideration that would affect the outcome of a negotiation in the free market." Written Direct Testimony of Michael Pelcovits, Docket No. 2005-1 CRB DTRA, at 4-8 (Oct. 31, 2005) (Ex. 3 hereto). SoundExchange does not, and cannot, explain how that testimony could be proper while at the same time Section III of Professor Katz's written direct testimony is improper.

Similarly, in both satellite digital audio radio services ("SDARS") proceedings, SoundExchange's expert, Professor Janusz Ordover, offered "an analysis of the policy objectives set forth in 17 U.S.C. § 801 (b)(1) . . . us[ing] the economic principles discussed above to assess the economic implications of each policy objective and to thereby translate each objective into economic criteria for establishing a rate for the license at issue." Written Direct Testimony of Janusz Ordover, Docket No. 2006-1 CRB DSTRA, at 21-34 (Oct. 30, 2006) (Ex. 4 hereto); *see*

also Written Direct Testimony of Michael Pelcovits, Docket No. 2006-1 CRB DSTRA, at 5 (Oct. 27, 2006) (Ex. 5 hereto) ("I adopt Dr. Ordover's view that here, the policy objectives set out by Congress are most fully satisfied by rates that would be the likely outcome of marketplace negotiations among the individual record companies and the individual SDARS."); Written Direct Testimony of Janusz Ordover, Docket No. 2011-1 CRB PSS/Satellite II, at 3 (Nov. 28, 2011) (Ex. 6 hereto) ("The core economic principle underlying my work in this matter is that the section 801(b)(1) statutory criteria are most consistent with the development of a royalty rate that approximates the terms that would be reached by the parties in an unfettered marketplace setting, *i.e.*, one free of the applicable compulsory licensing regime. Such a rate would reflect the value of sound recordings to Sirius XM subscribers, given the pricing and availability of other channels of distribution through which consumers are able to listen to music.").

SoundExchange's presentation of the kind of evidence that it now suggests is improper is not limited to past proceedings. Professor Daniel Rubinfeld, for example, offers extensive testimony on his views as to how economics informs a proper understanding of the willing buyer/willing seller framework. *See* Written Direct Testimony of Daniel L. Rubinfeld, at 27-30; *see also* Written Rebuttal Testimony of Daniel L. Rubinfeld, at 55 ("I agree with the CRB's consistent, long-standing view that the two specific considerations enumerated in the statutory standard – (i) the extent to which the service substitutes or promotes other streams of revenue and (ii) the parties' relative contributions – are both reflected in the rates negotiated by buyers and sellers in direct agreements."). Professor Talley provides similar opinions. Written Rebuttal Testimony of Eric L. Talley, Ph.D., at 4-5 (providing lengthy explanation of his "understanding" of the willing buyer/willing seller standard); *id.* at 18 (presenting his view of what is "important" "for purposes of determining a reasonable licensing fee in a WBWS framework").

SoundExchange presumably offered this testimony by Professors Rubinfeld and Talley for the same reason that NAB did: its belief that this testimony is helpful to understanding the economic principles that animate the willing buyer/willing seller standard.

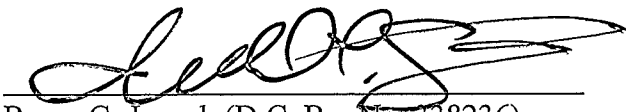
The above examples demonstrate how common and accepted this kind of testimony is in rate-setting proceedings before the Copyright Royalty Judges.[3] Professor Katz's testimony is consistent with a long tradition of offering economic testimony relevant to understanding the willing buyer/willing seller standard, is entirely proper, and should not be stricken.

[3] The ASCAP rate court similarly has accepted and relied upon testimony similar to Professor Katz's. For example, in a proceeding to determine rates for MobiTV, Inc., the ASCAP rate court extensively relied on the testimony of economics Professor Roger Noll, who "provided a detailed exposition of relevant economic principles and endorsed using wholesale revenue as the revenue base for the calculation of Mobi's licensing fee." *United States v. ASCAP* (*In re Application of MobiTV, Inc.*), 712 F. Supp. 2d 206, 244-45 (S.D.N.Y. 2010), *aff'd*, 681 F.3d 76 (2d Cir. 2012). Professor "Noll's discussion of economic principles includes a description of the principles of monopolistic competition, competitive pricing, and derived demand." *Id.* at 245 (footnote omitted). The ASCAP rate court credited Professor Noll with having "provided a theoretical basis for addressing this rate determination. This framework arises from his unquestioned expertise as an economist and his deep engagement with the industries at issue here. Both his qualifications and his detailed exposition of his analysis entitle his opinion to careful consideration." *Id.*

CONCLUSION

For the foregoing reasons, SoundExchange's Motion To Strike Section III of the written direct testimony of Professor Michael Katz should be denied.

Respectfully submitted,



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Dated: April 8, 2015

CURRICULUM VITAE

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EMPLOYMENT

July 1987 to present
Sarin Chair in Strategy and Leadership
Professor of Economics
University of California, Berkeley
Joint appointment in the Economics Department and Haas School of Business. Member, Academic Senate Committee on Budget and Interdepartmental Relations. Former Director of the Institute for Business Innovation and Associate Dean for Academic Affairs. Past chair of Economic Analysis and Policy Group, Strategic Planning Committee, and Policy & Planning Committee. Research areas include competition and public policy in network and system industries, innovation, and pricing. Principal teaching in areas of business strategy and microeconomics.

July 2007 to June 2009
Harvey Golub Professor of Business Leadership
New York University
Appointed to Department of Management and Organizations, Stern School of Business. Research areas included healthcare competition. Taught business strategy courses.

September 2001 to January 2003
Deputy Assistant Attorney General for Economic Analysis
U.S. Department of Justice
Oversaw economic analysis in support of all Antitrust Division enforcement activities. Reported directly to the Assistant Attorney General for Antitrust. Managed unit of approximately 55 professional economists. Undertook multidimensional effort to integrate economists more fully into investigation, decision, and litigation processes.

January 1994 to January 1996
Chief Economist
Federal Communications Commission
Responsible for integrating economics into all aspects of Commission policy making. Reported directly to the Chairman of the Commission. Formulated and implemented regulatory policies for all industries under Commission jurisdiction. Managed teams of lawyers and economists to design regulatory policies and procedures.

July 1981 to June 1987
Assistant Professor of Economics
Princeton University
Conducted research on sophisticated pricing, standards development, cooperative R&D, and intellectual property licensing. Served as Assistant Director of Graduate Studies. Taught courses in microeconomics, industrial organization, and antitrust and regulation.

EDUCATION

D.Phil. 1982
Oxford University
Doctorate in Economics. Thesis on market segmentation and sophisticated pricing.

A.B. *summa cum laude* 1978
Harvard University
As an undergraduate, completed courses and general examinations for Economics doctorate.

SERVICE

Coeditor, *Journal of Economics & Management Strategy,* 1991-2001 and 2003-present.

Editorial Board member, *Information Economics and Policy,* 2004-present.

Editorial Board member, *Journal of Industrial Economics,* 2007-present.

Editorial Board member, *California Management Review,* 1998-2000 and 2003-2007. Editor 2000-2001.

Board Member, Berkeley Executive Education, February 2013-present.

U.S. Advisory Board member, NTT DOCOMO, Inc., October 2011-April 2013.

Spectrum Policy Invited Expert, President's Council of Advisors on Science and Technology, September 2011-May 2012.

Member, Committee on Wireless Technology Prospects and Policy Options, The National Academies, 2003-2011.

Deputy Marriage Commissioner, City and Country of San Francisco, October 2, 2010.

Member, Computer Science and Telecommunications Board, The National Academies, 2000-2001 and 2004-2008.

Member, Spectrum Policy Working Group, Digital Age Communication Act Project, Progress & Freedom Foundation, January 2005-March 2006.

Member, Consumer Energy Council of America, Universal Service Forum, 2000-2001.

AWARDS AND HONORS

Chairman's Special Achievement Award, Federal Communications Commission, 1996.

The Earl F. Cheit Outstanding Teaching Award, University of California, Berkeley, 1992-1993 and 1988-1989. Honorable Mention, 1999-2000 and 1996-1997.

Alfred P. Sloan Research Fellow, 1985-1988.

National Science Foundation Graduate Fellow, 1978-1981.

John H. Williams Prize (awarded to the Harvard College student graduating in Economics with the best overall record), 1978.

GRANTS

Principal Investigator, Nokia Corporation grant on business-model innovation, 2009-2012.

Principal Investigator, Microsoft Corporation grant, "Research on Competition Policy for Intellectual Property," joint with Richard J. Gilbert, 2006

Recipient, Berkeley Committee on Research grant, 2004-2005, 1996-1997.

Recipient, Berkeley Program in Finance Research grant, 1990.

Researcher, Pew Foundation grant: "Integrating Economics and National Security," 1987-1990.

Principal Investigator, National Science Foundation grants:

"A More Complete View of Incomplete Contracts," joint with Benjamin E. Hermalin, 1991-1993.

"Game-Playing Agents and the Use of Contracts as Precommitments," 1988-1989.

"The Analysis of Intermediate Goods Markets: Self-Supply and Demand Interdependence," 1985-1986.

"Imperfectly Competitive Models of Screening and Product Compatibility," 1983-1984.

"Screening and Imperfect Competition Among Multiproduct Firms," 1982.

PUBLICATIONS

"Multiplant Monopoly in a Spatial Market," *Bell Journal of Economics* Vol. 11, No. 2 (Autumn 1980).

"Non-uniform Pricing, Output and Welfare Under Monopoly," *Review of Economic Studies* Vol. L, No. 160 (January 1983).

"A General Analysis of the Averch-Johnson Effect," *Economic Letters* Vol. 11, No. 3 (1983).

"The Socialization of Commodities," co-authored with L.S. Wilson, *Journal of Public Economics* Vol. 20, No. 3 (April 1983).

"The Case for Freeing AT&T," co-authored with Robert D. Willig, *Regulation* (July/August 1983) and "Reply to Tobin and Wohlstetter," *Regulation* (November/December 1983).

"Plea Bargaining and Social Welfare," co-authored with Gene M. Grossman, *American Economic Review* Vol. 73, No. 4 (September 1983).

"Firm-Specific Differentiation and Competition Among Multiproduct Firms," *Journal of Business* Vol. 57, No. 1, Part 2 (January 1984).

"Nonuniform Pricing with Unobservable Numbers of Purchases," *Review of Economic Studies* Vol. LI (July 1984).

"Price Discrimination and Monopolistic Competition," *Econometrica* Vol. 52, No. 6 (November 1984).

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"Tax Analysis in an Oligopoly Model," co-authored with Harvey S. Rosen, *Public Finance Quarterly* Vol. 13, No. 1 (January 1985). Reprinted in *The Distribution of Tax Burdens,* D. Fullerton and G.E. Metcalf (eds.), Camberley: Edward Elgar Publishing Ltd. (2003), and *The Economics of Taxation,* J. Alm (ed.), Cheltenham: Edward Elgar Publishing Ltd. (2011) .

"Network Externalities, Competition, and Compatibility," co-authored with Carl Shapiro, *American Economic Review* Vol. 75, No. 3 (June 1985). Reprinted in *Antitrust and Competition Policy*, A.N. Kleit (ed.), Camberley: Edward Elgar Publishing Ltd. (2005).

"On the Licensing of Innovations," co-authored with Carl Shapiro, *Rand Journal of Economics* Vol. 16, No. 4 (Winter 1985).

"Consumer Shopping Behavior in the Retail Coffee Market," co-authored with Carl Shapiro, in *Empirical Approaches to Consumer Protection* (1986).

"Technology Adoption in the Presence of Network Externalities," co-authored with Carl Shapiro, *Journal of Political Economy* Vol. 94, No. 4 (August 1986).

"How to License Intangible Property," co-authored with Carl Shapiro, *Quarterly Journal of Economics* Vol. CI (August 1986).

"An Analysis of Cooperative Research and Development," *Rand Journal of Economics* Vol. 17, No. 4 (Winter 1986).

"Product Compatibility Choice in a Market with Technological Progress," co-authored with Carl Shapiro, *Oxford Economic Papers: Special Issue on Industrial Organization* (November 1986).

"The Welfare Effects of Third-Degree Price Discrimination in Intermediate Goods Markets," *American Economic Review* Vol. 77, No. 2 (March 1987).

"R&D Rivalry with Licensing or Imitation," co-authored with Carl Shapiro, *American Economic Review* Vol. 77, No. 3 (June 1987).

"Pricing Publicly Provided Goods and Services," in *The Theory of Taxation for Developing Countries*, D.M. Newbery and N.H. Stern (eds.), Washington, D.C.: World Bank (1987).

"Vertical Contractual Relationships," in *The Handbook of Industrial Organization*, R. Schmalensee and R.D. Willig (eds.), Amsterdam: North Holland Publishing (1989).

"R&D Cooperation and Competition," co-authored with Janusz A. Ordover, *Brookings Papers on Economic Activity: Microeconomics* (1990).

Intermediate Microeconomics, co-authored with Harvey S. Rosen, Burr Ridge, IL: Richard D. Irwin (1st ed. 1991, 2nd ed. 1994, 3rd ed. 1997). Translated into Italian and Russian.

"Game-Playing Agents: Unobservable Contracts as Precommitments," *Rand Journal of Economics* Vol. 22, No. 3 (Autumn 1991).

PUBLICATIONS continued

"Moral Hazard and Verifiability: The Effects of Renegotiation in Agency," co-authored with Benjamin E. Hermalin, *Econometrica* Vol. 59, No. 6 (November 1991).

"Product Introduction with Network Externalities," co-authored with Carl Shapiro, *Journal of Industrial Economics* Vol. XL, No. 1 (March 1992).

"Defense Procurement with Unverifiable Performance," co-authored with Benjamin E. Hermalin, in *Incentives in Procurement Contracting*, J. Leitzel and J. Tirole (eds.), Boulder, Colorado: Westview Press (1993).

"Judicial Modification of Contracts Between Sophisticated Parties: A More Complete View of Incomplete Contracts and Their Breach," co-authored with Benjamin E. Hermalin, *Journal of Law, Economics, & Organization* Vol. 9, No. 2 (1993).

"Systems Competition and Network Effects," co-authored with Carl Shapiro, *Journal of Economic Perspectives* Vol. 8, No. 2 (Spring 1994).

"Joint Ventures as a Means of Assembling Complementary Inputs," *Group Decision and Negotiation* Vol. 4, No. 5 (September 1995). Also printed in *International Joint Ventures: Economic and Organizational Perspectives*.

"Interconnecting Interoperable Systems: The Regulator's Perspective," co-authored with Gregory Rosston and Jeffrey Anspacher, *Information, Infrastructure and Policy,* Vol. 4, No. 4 (1995).

"Interview with an Umpire," in *The Emerging World of Wireless Communications,* Annual Review of the Institute for Information Studies (1996).

"An Analysis of Out-of-Wedlock Childbearing in the United States," co-authored with George Akerlof and Janet Yellen, *Quarterly Journal of Economics* Vol. 111, No. 2 (May 1996).

Reprinted in *Explorations in Pragmatic Economics: Selected Papers of George A. Akerlof and Co-Authors*, Oxford: Oxford University Press (2005).

"Remarks on the Economic Implications of Convergence," *Industrial and Corporate Change* Vol. 5, No. 4 (1996).

"Regulation to Promote Competition: A first look at the FCC's implementation of the local competition provisions of the telecommunications act of 1996," co-authored with Gerald W. Brock, *Information Economics and Policy* Vol. 9, No. 2 (1997).

"Ongoing Reform of U.S. Telecommunications Policy," *European Economic Review* Vol. 41 (1997).

"Economic Efficiency, Public Policy, and the Pricing of Network Interconnection Under the Telecommunications Act of 1996," in *Interconnection and the Internet: Selected Papers from the 1996 Telecommunications Policy Research Conference,* G. Rosston and D. Waterman (eds.), Mawah, New Jersey: Lawrence Erlbaum Associates, Publishers (1997).

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"Introduction: Convergence, Competition, and Regulation," co-authored with Glenn A. Woroch, *Industrial and Corporate Change* Vol. 6, No. 4 (1997).

"Public Policy and Private Investment in Advanced Telecommunications Infrastructure," co-authored with Joseph Farrell, *IEEE Communications Magazine* (July 1998).

"The Effects of Antitrust and Intellectual Property Law on Compatibility and Innovation," co-authored with Joseph Farrell, *The Antitrust Bulletin* Vol. 43, No. 3/4 (Fall/Winter 1998).

"Antitrust in Software Markets," co-authored with Carl Shapiro, in *Competition, Innovation and the Microsoft Monopoly: Antitrust in the Digital Marketplace*, J.A. Eisenach and T. Lenard (eds.), Boston: Kluwer Academic Publishers (1999).

"Regulation: The Next 1000 Years" in *Six Degrees of Competition: Correlating Regulation with the Telecommunications Marketplace,* Washington, D.C.: Aspen Institute (2000).

"The Business of Health Care Affects Us All: An Introduction," co-authored with Sara Beckman, *California Management Review* Vol. 43, No. 1 (Fall 2000).

"Innovation, Rent Extraction, and Integration in Systems Markets," co-authored with Joseph Farrell, *Journal of Industrial Economics* Vol. XLVIII, No. 4 (December 2000).

"Diversification and Agency," co-authored with Benjamin Hermalin, in *Incentives, Organization, and Public Economics: Papers in Honour of Sir James Mirrlees,* P. Hammond and G. D. Myles (eds.), Oxford University Press (2001).

"Thoughts on the Implications of Technological Change for Telecommunications Policy," in *Transition to an IP Environment,* Washington, D.C.: Aspen Institute (2001).

"An Economist's Guide to *U.S. v. Microsoft*" co-authored with Richard Gilbert, *Journal of Economic Perspectives* Vol. 15, No. 2 (Spring 2001).

"When Good Value Chains Go Bad: The Economics of Indirect Liability for Copyright Infringement," co-authored with Richard Gilbert, *Hastings Law Journal* Vol. 52, No. 4 (April 2001).

"Intellectual Property Rights and Antitrust Policy: Four Principles for a Complex World," *Journal on Telecommunications & High Technology Law* Vol. 1, Issue 1 (2002).

"Recent Antitrust Enforcement Actions by the U.S. Department of Justice: A Selective Survey of Economic Issues," *Review of Industrial Organization* Vol. 21, No. 4 (December 2002).

"Critical Loss: Let's Tell the Whole Story," co-authored with Carl Shapiro, *Antitrust* Vol. 17, No. 2 (Spring 2003).

"Retail Telecommunications Pricing in the Presence of External Effects," co-authored with Benjamin Hermalin, in *International Handbook on Emerging Telecommunications Networks,* G. Madden (ed.), Camberley: Edward Elgar Publishing Ltd. (2003).

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"Television Over the Internet: Industry Structure and Competition Absent Distribution Bottlenecks," in *Internet Television*, E.M. Noam, J. Groebel, and D. Gerbarg (eds.), Mawah, New Jersey: Lawrence Erlbaum Associates, Publishers (2003).

"The Role of Efficiency Considerations in Merger Control: What We Do in the U.S.," in *EC Merger Control: A Major Reform in Progress,* G. Drauz and M. Reynolds (eds.), Richmond, England: Richmond Law & Tax Ltd. (2003).

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Before the
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In The Matter Of:	)	
Determination of Royalty Rates for Digital Performance in Sound Recordings and Ephemeral Recordings (Web IV)	)	14-CRB-0001-WR (2016-2020)

WRITTEN DIRECT TESTIMONY OF MICHAEL L. KATZ

(On behalf of the National Association of Broadcasters)

October 7, 2014

court. I have also provided testimony before state regulatory commissions and the U.S. Congress. In addition, I was commissioned by the Congressional Research Service to write a report on the economic effects of home copying on the markets for recorded music and for electronically recorded visual images.[9]

10. From January 1994 through January 1996, I served as the Chief Economist of the Federal Communications Commission. I participated in the formulation and analysis of policies toward all industries under Commission jurisdiction. As Chief Economist, I oversaw both qualitative and quantitative policy analyses.

11. From September 2001 through January 2003, I served as the Deputy Assistant Attorney General for Economic Analysis at the U.S. Department of Justice. I directed a staff of approximately fifty economists conducting analyses of economic issues arising in both merger and non-merger enforcement. My title as Deputy Assistant Attorney General notwithstanding, I am not an attorney.

12. I have also advised private clients on software licensing fees and product pricing.

III. THE STATUTORY STANDARD

13. Section 114 of the Copyright Act establishes a "willing buyer/willing seller" standard for the setting of statutory royalty rates applicable in this proceeding:[10]

> In establishing rates and terms for transmissions by eligible nonsubscription services and new subscription services, the Copyright

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9 Michael L. Katz , *Home Copying and Its Economic Effects: An Approach for Analyzing the Home Copying Survey,* Mar. 9, 1989, report commissioned by Congressional Research Service for *Copyright and Home Copying: Technology Challenges to the Law,* October 1989.

10 Copyright Act, 17 U.S.C. § 114(f)(2)(B).

> Royalty Judges shall establish rates and terms that most clearly represent the rates and terms that would have been negotiated in the marketplace between a willing buyer and a willing seller. In determining such rates and terms, the Copyright Royalty Judges shall base their decision on economic, competitive and programming information presented by the parties, including—
>
> > (i) whether use of the service may substitute for or may promote the sales of phonorecords or otherwise may interfere with or may enhance the sound recording copyright owner's other streams of revenue from its sound recordings; and
> >
> > (ii) the relative roles of the copyright owner and the transmitting entity in the copyrighted work and the service made available to the public with respect to relative creative contribution, technological contribution, capital investment, cost, and risk.

14. If interpreted literally and narrowly, the willing-buyer/willing-seller standard would exhibit a broad range of indeterminacy in the level of license fees. An economically rational party will not agree to a transaction that makes it worse off. This fact implies that:

- a seller will not agree to a price below its marginal or incremental cost of providing the good or service, including the opportunity cost of doing so; and
- a buyer will not agree to a price above the value that it derives from the good or service.

15. Conversely, faced with an all-or-nothing choice, a rational party will be "willing" to agree to a contract as long as it leaves that party in no worse a position than it would be in absent the agreement. Hence, interpreted in a narrow, literal sense, any price above marginal cost could be considered to be price at which a seller would be willing to transact. And, under this literal interpretation, even a monopolist charging the monopoly price would constitute a willing seller that faces willing buyers.

16. This literal reading of the standard is untenable for at least two reasons. First, there typically will be a very large gap between marginal cost (the minimum price that a seller is "willing" to accept) and the highest price at which a buyer would be willing to purchase at least some of the good, which typically will be even higher than the monopoly price. Hence, this interpretation would provide essentially no guidance for rate setting. Second, an interpretation under which even a monopolist charging the monopoly price would constitute a willing seller facing willing buyers would be inconsistent with past Congressional actions. Specifically, from the perspective of economics, it would make no sense for Congress to have enacted a statutory rate-determination process if Congress intended that monopolistic license fees could meet the statutory standard. If Congress had intended monopoly rates to prevail, then it could simply have created the statutory license and given SoundExchange antitrust immunity unilaterally to set rates on behalf of the industry. Congress did not do so.

17. The creation of a rate-determination process and its willing-buyer/willing-seller standard can best be reconciled with economic principles and common sense by interpreting willing buyers as those who have meaningful choices among competing sellers, rather than facing a single, all-or-nothing offer from a monopolist. This interpretation is fully consistent with the Librarian of Congress's recognition in Web I that the willing-buyer/willing-seller standard calls for rates that would have been set in a "competitive marketplace."[11] In related proceedings, an economist repeatedly retained by

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[11] *Determination of Reasonable Rates and Terms for the Digital Performance of Sound Recordings and Ephemeral Recordings*, Final Rule and Order, 67 FR 45240 (July 8, 2002) (hereinafter, *Web I Decision*), at 45244-45.

SoundExchange agreed that, in order for a privately negotiated licensing agreement to serve as an appropriate benchmark there should not be excessive market power on either the buyer side or the seller side of the market,[12] and in a similar proceeding testified that,[13]

> for an economist, absent a public policy decision actually to *distort* pricing structure (through taxes or subsidies), the fundamental objective in a rate setting proceeding such as [SDARS I] should be to "mimic" what an effectively competitive marketplace accomplishes in an unregulated setting...

18. As I will now discuss, an effective-competition standard resolves the indeterminacy identified above, and it does so by identifying prices near marginal or incremental costs as the appropriate level.

IV. THE ECONOMICS OF EFFECTIVE COMPETITION

19. The degree of market competitiveness lies on a spectrum. At one end, there are markets satisfying the textbook conditions of perfect competition, with rivalry among a large number of sellers of identical products and the possibility of free entry into the

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[12] In the previous proceeding, *Determination of Royalty Rates for Digital Performance Right in Sound Recordings and Ephemeral Recordings* (hereinafter, Web III), SoundExchange's economic expert, Professor Janusz Ordover, testified that

> [c]onsistent with my testimony in the SDARS Proceeding, and more generally with a sound economic approach to the determination of rates that best conduce to long-run economic efficiency, licensing rates negotiated in an unfettered marketplace, that is, in a marketplace free of regulatory compulsion and undue market power on either side of the bargaining table, represent benchmarks that are most closely aligned with the statutory requirement.

(Written Rebuttal Testimony of Janusz Ordover, *Digital Performance Right in Sound Recordings and Ephemeral Recordings*, June 7, 2010 (hereinafter *Ordover WRT Web III*) at 5.)

[13] Testimony of Janusz Ordover, *Adjustment of Rates and Terms for Preexisting Subscription Services and Satellite Digital Audio Radio Services*, October 30, 2006 (hereinafter, *Ordover WDT SDARS I*), at 12.

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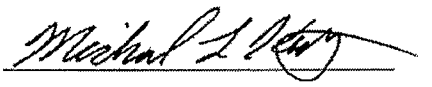
In The Matter Of:	)	
Determination of Royalty Rates for Digital Performance in Sound Recordings and Ephemeral Recordings (Web IV)	)	**14-CRB-0001-WR (2016-2020)**

DECLARATION OF MICHAEL L. KATZ

I, Michael L. Katz, declare under penalty of perjury under the laws of the United States that the matters set forth in my Written Direct Testimony in the above-captioned proceeding are true and correct to the best of my knowledge, information and belief.

Executed on this 7th day of October, 2014.



Michael L. Katz

Before the
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In the Matter of DIGITAL PERFORMANCE RIGHT IN SOUND RECORDINGS AND EPHEMERAL RECORDINGS	)	Docket No. 2005-1 CRB DTRA

TESTIMONY OF

MICHAEL PELCOVITS

Principal, Microeconomic Consulting & Research Associates (MiCRA)

PUBLIC VERSION

October 2005

Section VII presents evidence on copyright fees in some other markets, which serve to verify the methodology and recommendations that I have made. Finally, in Section VIII, I discuss the rapidly evolving market for streaming services provided on mobile devices. Music services may utilize the statutory license to make transmissions to mobile devices, and in the free market copyright owners would command a premium for a distribution of their works in any fashion that makes them portable or accessible via a wireless device. I propose that the Board establish royalty rates that recognize this market premium placed on mobile services.

III. FRAMEWORK FOR ANALYZING THE WILLING BUYER/WILLING SELLER STANDARD

A. Willing Buyer/Willing Seller Standard

In its prior decision setting the compulsory license fees for non-subscription, non-interactive webcasting, a Copyright Arbitration Royalty Panel ("CARP") ruled that "the willing buyer/willing seller standard is the *only* standard to be applied."[3] The Panel explained that the two other factors enumerated in the statute (i.e., substitution/promotion effects on phonorecords, and relative roles of the parties) do not constitute additional standards or policy considerations.[4]

I am in complete agreement that the willing buyer/willing seller standard can and should be interpreted broadly enough to encompass these two other factors and any other consideration that would affect the outcome of a negotiation in the free market. Markets function very effectively to take account of all the considerations that are important to

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[3] *In re Rate Setting for Digital Performance Right in Sound Recordings and Ephemeral Recordings*, No. 2000-9 CARP DTRA 1&2, slip op. at 21 (CARP Feb. 20, 2002) (Report of the Copyright Arbitration Royalty Panel to the Librarian of Congress).
[4] *Id.*

buyers and sellers. By using a benchmark analysis, I avoid the necessity of having to separately value each of the considerations relevant to buyers and sellers, because the market already has done so -- my task is simply to adjust for any relevant differences between the benchmark market and the market at issue here.

B. The Marketplace

I also understand that the willing buyer under this statutory standard is a webcasting service that seeks to make non-interactive transmissions of copyrighted sound recordings to consumers. The willing seller is an owner of copyrights in a single or multiple sound recordings, usually a record company. I further assume that no party has monopoly power, but that the owner of copyrighted sound recordings has, due to the nature of the copyright itself as a monopoly, a unique asset that is different from the bundle of sound recordings offered by other copyright owners.

I also assume that an individual webcaster will seek to obtain the best price that it can in the marketplace and that it might forego providing some digital music services if others are more profitable. Similarly, an individual record company will try to maximize profits across all of its various revenue streams. Such behavior is consistent with the concept of a willing seller of a differentiated product in a competitive market. Thus, for example, the willing seller might set a higher rate in a market than it otherwise would, if sales in that market would substitute for more profitable sales in a different market.

I also assume that both the willing buyer and willing seller in this hypothetical marketplace are commercial entities fully motivated to maximize profits. "Sellers expect to make a profit and will extract from the market what they can, just as buyers will do everything in their power to get the product at the lowest possible price." *Determination*

of Reasonable Rates and Terms for the Digital Performance of Sound Recordings and Ephemeral Recordings, 67 Fed. Reg. 45,240, 45,245 (July 8, 2002) ("67 Fed. Reg. 45,240"). Thus, I do not attempt to set separate rates for noncommercial entities or hobbyists that are not seeking to maximize profit, or even those small webcasters that may be unable to survive without the benefit of a below-market statutory license. As the Librarian has explained, the willing buyer/willing seller standard requires the setting of rates "that a willing buyer and willing seller would have agreed upon in a hypothetical marketplace that was not constrained by a compulsory license." *Id.* at 45,244.

That a rate might cause consolidation in the marketplace for webcasting is neither a bad nor a good thing. It is, however, the way that a free market economy functions. Firms in a free market are free to thrive and free to fail. Almost all markets go through constant changes as firms enter and exit the business. Indeed, a rate that is set too low may have serious economic dangers. By setting the rate too low, inefficient entry may be encouraged, and inefficient levels of production will be encouraged, which can hinder the development of an efficient market. It is also worth noting that setting the statutory rate too high will not necessarily be harmful to the market. If the price is too high, parties can (and are almost certain to) negotiate agreements for rates lower than the statutory standard. Thus, a rate set too high is likely to "self-adjust" because of the sellers' natural incentive to meet the market. But a rate set too low will create permanent distortion because there is no incentive for the buyers to pay extra -- they may obtain the product at the lower rate without any market correction.

C. *The Product*

In evaluating this market, I have understood the product at issue to be a blanket license from a record company "which allows use of that company's complete repertoire of sound recordings." 67 Fed. Reg. 45,240, 45,244. This license includes only a license for the sound recording copyright, not the separate musical works copyright. It is worth noting that this is not necessarily the equilibrium that a free market would have reached. Willing sellers may have refused to license certain sound recordings (for any of a number of reasons), may have required premium payments for certain sound recordings, or may have held back some sound recordings from widespread distribution in order to offer exclusive deals to a single music service.

I also understand the product to be offered to be a license for non-interactive (as that term is defined in the statute) webcasting, including the right to provide such a service through the making of multiple ephemeral copies used to facilitate transmissions and performing copyrighted sound recordings through digital audio transmissions. Although there are two separate rights at issue (reproduction and performance), each with independent value, I have not sought to quantify them separately in this report. It appears that, in the current marketplace, parties negotiate for a single rate to encompass both the public performance and the reproduction rights.

Finally, I am aware that there may be disputes between record companies and webcasters concerning the definition of "non-interactive" under the statute and thus disputes over the scope of services that fall inside and outside the statutory license. I take no position on that legal issue. For purposes of this analysis, I have presumed that non-interactive webcasting does not permit any form of user input to "customize" particular

stations. As noted below, to the extent that the statutory license allows any degree of customization, its value would almost certainly increase and the royalty would have to increase as well.

IV. NEGOTIATED RATES FROM SIMILAR MARKETS SHOULD BE USED AS THE BENCHMARK FOR THE COMPULSORY LICENSE

In the discussion below, I will describe the nature of the supply and demand side of the hypothetical market for blanket licenses to use copyrighted sound recordings. Although the market is hypothetical, the participants are not, and it is possible to gain a very good understanding of the likely behavior of the participants were it not for the compulsory license. By looking carefully at the characteristics of the music services offered in the market, I have been able to derive proposed fee levels and a rate structure for the compulsory licenses that should closely approximate the result of a market negotiation between willing buyers and willing sellers.

I recommend that the Copyright Royalty Board adopt compulsory license fees for non-interactive digital audio transmissions ("NI-DATs") derived from current market negotiated rates for copyright licenses used by music services providing interactive digital audio transmissions (interactive DATs). These benchmarks can be used for the compulsory fee after adjusting for the different characteristics of the two markets. I believe that benchmarking is superior to other approaches that might be proposed in this proceeding or to techniques that economists have used in other contexts. The reason for this is that there are reliable, comprehensive, and statistically meaningful data available on negotiated prices in the market for interactive DATs, which is nearly identical to the

I declare under penalty of perjury that the foregoing testimony is true and correct to the best of my knowledge.

Michael D. Pelcovits

Michael D. Pelcovits

Date: 10-31-05

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In the Matter of	)	
ADJUSTMENT OF RATES AND TERMS FOR PREEXISTING SUBSCRIPTION SERVICES AND SATELLITE DIGITAL AUDIO RADIO SERVICES	)	Docket No. 2006-1 CRB DSTRA

TESTIMONY OF

JANUSZ ORDOVER

Professor of Economics
and former Director of the Masters in Economics Program at New York University

PUBLIC VERSION

October 2006

In the instant case, an additional complication arises from the fact that record companies are allowed jointly to negotiate license fees with the SDARS under the auspices of SoundExchange. Such an arrangement is efficient because it minimizes transactions costs and also obviates a concern – whether real or not – that one record company will attempt to "hold up" a provider of satellite radio service.[16] Hence, even if an individual record company may lack substantial market power, record companies negotiating as a single entity likely will have such power. It is therefore important to ensure that the rates that would emerge from a hypothetical arm's length negotiation between SoundExchange and the SDARS are free of any "monopoly profits" that might be created by the statutory framework which gives SoundExchange the ability to represent all sound recording copyright holders collectively. The best way to protect against this result is to rely on actual marketplace rates (or analysis that is intended to yield marketplace rates), since in the marketplace it is the individual record companies, and not SoundExchange, that bargain and enter into agreements with distributors.

E. Conclusion

In sum, rates should reflect purchasers' willingness to pay for the music content. That is, they should reflect the value of the music content to the SDARS and to their subscribers, as embedded in the principles of value-based pricing. In this way, the Court-determined rates will properly balance the goals of static and dynamic efficiency. As I noted earlier, the most effective way to construct such a rate is to mimic rates set in the marketplace for sound recordings.

IV. THE ECONOMIC IMPLICATIONS OF THE SECTION 801(b) POLICY OBJECTIVES

In Sections II and III above, I laid out the basic rules for setting prices when the theoretical ideal of marginal cost pricing is not feasible. I explained, in particular, why efficient pricing of intellectual property, as opposed to more standard products, cannot be resolved simply by identifying the product's marginal cost. I now turn to an analysis of

[16] This issue is addressed by Dr. Pelcovits who uses "Shapley value" as a solution to a cooperative game bargaining model for deriving an appropriate license fee.

the policy objectives set forth in 17 U.S.C. § 801(b)(1) with this basic concept in mind. In particular, I use the economic principles discussed above to assess the economic implications of each policy objective and to thereby translate each objective into economic criteria for establishing a rate for the license at issue. I conclude that the first three factors in particular focus on the trade-off between the need for incentives to create content such as music and the legitimate goal of ensuring its dissemination to the listening public.

The list below spells out the policy objectives that apply to setting the rate for the blanket license at issue in this case:

(A) To maximize the availability of creative works to the public;

(B) To afford the copyright owner a fair return for his creative work and the copyright user a fair income under existing economic conditions;

(C) To reflect the relative roles of the copyright owner and the copyright user in the product made available to the public with respect to relative creative contribution, technological contribution, capital investment, cost, risk, and contribution to the opening of new markets for creative expression and media for their communication; and

(D) To minimize any disruptive impact on the structure of the industries involved and on generally prevailing industry practices.

I now address each objective in turn.

Objective 1: To Maximize the Availability of Creative Works to the Public

In principle, this objective is best advanced by a market-based rate that sends the correct incentives both to copyright holders and to distributors of creative content. This factor has a clear economic interpretation in terms of the principles laid out above. I understand that this panel's precedent establishes this first objective as principally focused on the adequate provision of incentives for the "production" of *new* creative works.[17] These incentives are most potent when creators of content receive sufficient

[17] Determination of Reasonable Rates and Terms for the Digital Performance of Sound Recordings, 63 Fed. Reg. 25394, 25406-25407 (May 8, 1998).

compensation for their creative efforts, while the distributors of content have sufficient incentives to deliver the content to potential users. Put another way, as I understand it, this objective should not be interpreted as compelling a blanket license to access a given stock of sound recordings that maximizes distributors' profits. Rather, the objective is best interpreted as implying that license fees should promote creation of new content while maintaining the viability of various distribution channels that are attractive to the listening public.

In order to satisfy this policy objective, the blanket license rate must be high enough so that it does not constrict the future supply of sound recordings below the socially efficient level, and not so high as to expropriate the SDARS' competitive returns. At the minimum, this requires that expected risk-adjusted returns to creating new sound recordings as determined by license revenues from feasible distribution channels should at least recover the associated expected fixed and variable costs incurred by the creators of new sound recordings in the aggregate. In addition, the blanket rate should not undermine record companies' earnings in other channels or create competitive distortions among channels.

According to the economic rules described in Section III above, the license fee contribution from any given distribution channel should reflect the value of sound recordings in that channel as measured by the elasticity of demand for sound recordings, and the cross-elasticities of demand between the channel under consideration and the alternative modes of distribution.

The survey data and results obtained by Dr. Yoram Wind are highly informative regarding the role of music in attracting SDARS subscribers and strongly support the proposition that a representative subscriber to satellite radio values music programming substantially more than the other programming delivered by the SDARS. Nearly one-half (43%) of all respondents indicated that they would cancel the service if it lacked music, a percentage that was triple that obtained with respect to any other type of programming (*e.g.*, talk shows or sports). Respondents were also asked to assign 100 points among seven satellite radio programming types in proportion to the relative importance respondents placed on them. Music, on average, received 44 points, again

triple the average amount ascribed to any other programming type. Moreover, 74% of respondents assigned the highest number of points to music programming, a full four times the level for any other type of content. Finally, in response to a query regarding the type of programming transmitted on satellite radio that would be missed the most if not available, 50% of respondents cited music. No other category of content was cited by more than 16% of respondents.

Thus, given the critical importance of music in attracting subscribers to satellite radio, it is reasonable to assume that the blanket license and the sound recordings it covers account for a substantial share of the SDARS' value, and therefore should receive a substantial share of that value. Of course, there is a limit on how much of that value could accrue to the record companies. In particular, the elasticity of demand for sound recordings by the SDARS is not zero: that is, an increase in a blanket license fee to some high level would induce the SDARS to substitute other content for music. Moreover, higher blanket license fees may result in higher subscription rates, and thus in fewer subscribers.

These considerations limit the rates that the record companies would be able or willing to set by means of individual bargains in the open market for blanket licenses to their individual repertoires.[18] This is so because the dollar volume of fees each record company is able to collect depends, in the end, on the number of customers that the SDARS (and all other music distribution channels) are able to attract. These individually negotiated blanket license fees thus likely will reflect the value of the individual repertoires, and the licensor's estimate of the record companies' ability to deliver value through future releases, as constrained by competition among record companies. Because these types of considerations play themselves out in other licensing venues, license fees negotiated individually by record companies in such other venues provide useful benchmarks for the blanket rate at issue here.

[18] Moreover, from the standpoint of a single record company, an increase in its demanded rate relative to what rivals charge would place it in a weaker position *vis-à-vis* the other record companies.

Voluntarily-negotiated pricing of content in fact reflects a legislative judgment about the extent to which intellectual property holders should be compensated for their creative efforts. Because Congress granted the copyright holder substantial property rights in the first instance, and thus potentially substantial negotiating power, market-based rates provide the copyright holder with as much of the surplus (value) generated through the use of its intellectual property as the marketplace will permit. The copyright law grants the author a "monopoly" over a particular form of expression of an idea: it gives the owner the right to exclude non-payers from using the property (assuming that anyone actually wants to pay anything for it). Although such protection does not generally impart *monopoly power* to the copyright owner, it does lead to a market setting in which the owner of the copyright does not face competition from an identical product (unlike a producer of steel or wheat, for example).[19] In that way – by creating the right to exclude and the right to an expression – Congress itself has created a system designed to maximize the availability of creative works to the public, and that system is based on the operation of market forces under the umbrella of copyright law.

The value to the licensee of copyrighted creative works thus is most clearly revealed in voluntary transactions reached through negotiations and other market mechanisms, either with (some) distributors of digital content, or directly with consumers.

Objective 2: To Afford the Copyright Owner a Fair Return for His Creative Work and the Copyright User a Fair Income Under Existing Economic Conditions

The second policy objective requires "fairness" for both the copyright owner and the copyright user under "existing economic conditions." "Fairness" is not a core economic concept. Insofar as it has a basis in economics, it relates to the outcomes that arise through unfettered market interactions in workably-competitive markets, that is, in markets that are not distorted by undue exercise of monopoly (seller) or monopsony

[19] This is not to say that, in this digital day and age, that the copyright owner does not face competition from almost identical purloined versions of its copyrighted product, such as illegal CDs or downloads.

(buyer) power. From that perspective, then, "fairness" too is achieved by maintaining consistency with rates that are the result of market-based transactions.

A market transaction occurs only if both sides find it desirable as compared to the alternative, *i.e.*, not transacting with each other. Since market transactions are voluntary, it follows that prices (here licensing rates) that emerge through this voluntary process should be deemed fair in this basic sense. From the social welfare standpoint, prices determined by unfettered marketplace interactions reflecting users' willingness to pay and suppliers' production costs can be said to result in a "fair" outcome for both sides, and also in an outcome that is efficient in the sense that it may not be possible to change these allocations through regulatory or other interventions without at the same time reducing *aggregate* economic welfare. Therefore, the equilibrium price arrived at through unfettered marketplace interactions can be said to result in a "fair" division of benefits from transactions over the long run.

This said, it is important, in my opinion, to avoid several pitfalls which might improperly be introduced into the public policy debate about the proper level of a blanket rate under the rubric of "fairness."

First, it would not conduce to achieving the goal of "fairness" to set a very low blanket because some portion of the recorded music played on satellite radio is comprised of past repertoire (*i.e.*, the "catalog"). As explained earlier, copyright owners base their decisions on the expected future flows of revenues from all available sources. Hence, arbitrarily truncating these flows will lead to dynamic inefficiency in the form of reduced future supply of output.[20]

Second, it is not uncommon in the marketplace for a producer to sell its products at a low price to a start-up distributor because it may be in the producer's long-term interest to promote an additional distribution outlet for its product. But in the marketplace, such "introductory" low rates will not persist once the buyer grows in size. Indeed, such low rates will not persist even if the buyer – either because of high costs or

[20] Of course, the copyright law truncates the flow of revenues at the time the copyright expires.

lack of appeal of its product or service – does not achieve economic viability. Thus, an introductory low rate is "fair" by market standards – inasmuch as it was voluntarily set by the seller – but it ceases to be "fair" when the purchaser attains viability, or at least has had sufficient opportunity to become viable, but nevertheless turns to regulation (or other means) to lock in the rate. In the instant context, there is no reason – and in fact would be bad economics and public policy – that the recording companies should be asked to reduce the risk of failure of satellite radio by charging below-market rates for their content.

Third, it might be in a licensor's private interest to offer a low rate to a start-up distributor, but only if other content providers are doing the same. Otherwise, the content provider who offers a discounted rate may not be advancing its own business interests, but simply transferring wealth to the buyer, and potentially enabling the buyer to make better deals with providers of competitive content. It is conceivable that the SDARS could rationally persuade the record companies to charge them a low rate during the start-up period. It is less conceivable that the record companies would accept such a rate if the SDARS were at the same time offering highly lucrative deals to other content providers such as Howard Stern and Major League Baseball, for example. Thus, marketplace evidence on the terms of freely negotiated contracts with other content providers is relevant both to gauging the willingness of recording companies to offer "introductory" rates, and also to assessing the willingness and ability of the SDARS to pay for attractive content.

In sum, I see no basis on "fairness" grounds for imposing on record companies and artists a rate in this case that would deviate from what would be freely determined through negotiations in the marketplace. Setting a blanket license rate at substantially below market rate is a prescription for inefficiency and inimical to sound public policy. A below-market rate would amount to "subsidizing" the SDARS, which would have the undesired effects of both giving the SDARS an undue competitive advantage *vis-à-vis* other distributors of music, and weakening the incentives for production of new recordings and for efficient distribution of music in the new media. Regulators rarely establish such "below-market" rates. They typically do so only when confronted with a

clear legislative mandate to create such a rate. Such rates are the exception rather than the rule, and there is no sound economic or public policy reason to implement such rates through this proceeding. This admonition applies, of course, not only to the rate to be paid by the SDARS but (plainly) also to the rate to be received by record companies. Deviation from a competitive market rate in either direction does not conduce to short-term and long-term economic efficiency.

Finally, the economic consequences of setting the rate "too high" are likely to be less severe than if the rate is set "too low." The rate established through the regulatory process establishes a ceiling. If this maximum rate is so high that it undermines the SDARS' business model, the parties can negotiate a lower rate that is more conductive to dissemination of content *via* satellite radio networks. The record companies have an incentive to agree to a lower rate if the statutory rate were set too high. In the context of individual negotiations, a copyright holder would receive no benefit from setting a license fee that is "too high," because it would significantly curtail dissemination of music over satellite radio networks (or eliminate it altogether) relative to the level that would be attained in a well-functioning market.[21]

On the other side of the table, if confronted with a mandated rate that is too low, the record companies have no choice but to license their sound recording repertoires, even if, as a result, they are not obtaining a warranted contribution from satellite radio to their overall return on their portfolio of recordings. While in the short-run, a blanket license that is too low likely will not affect either the demand for or the supply of already-recorded performances of music, in the long-run, an inefficiently low price will reduce the supply of new recordings, which is inimical to the public policy goals stated in Objective 1.

Further, as described above, the detrimental effect to society of setting a fee for the compulsory license that is too low relative to benchmark market rates extends beyond

[21] Market rates in other channels reflect whatever legitimate pricing flexibility recording companies have as a result of developing attractive recording assets whose use is protected by copyright. I have seen no evidence that these rates reflect "monopoly power" rather than competitive pricing of differentiated products.

the reduced supply of new recordings; it effectively results in a subsidy to the SDARS by allowing them to pay less for the licenses than their value would command in the market. Such a subsidy likely will stimulate growth of satellite radio but only because of undue cost advantage. And, because satellite radio is, to varying degrees, substitutable for other channels through which recorded music is distributed to listeners, subsidizing satellite radio necessarily will divert sales from these other distribution channels. This diversion will occur even if these alternative modes of distribution are more efficient relative to satellite radio, and as a result society's resource costs of music distribution will needlessly increase. Moreover, from the standpoint of the record companies, diversion of the sort I describe will lower their returns from both satellite radio and other distribution systems, which would be forced to lower their own rates (and ultimately lower the amount they pay to the copyright holder) in response to a subsidized rate. In sum, in considering the second factor, the social costs of setting a rate too low exceed the social costs of setting it too high.

Objective 3: To Reflect the Relative Roles of the Copyright Owner and the Copyright User with Respect to Their Relative Creative and Technological Contributions, Cost, Risk, and Contribution to the Opening of New Markets for Creative Expression

The public policy goals of this Objective too are best attained by setting the license fee in a manner that reflects the level of the fees that would be set in the market. Markets properly reward and take account of capital investment, the costs and risks involved in deploying the facilities and infrastructure necessary to produce a good or service, and each of the other considerations listed in this factor. Specifically, the third objective invokes several economic considerations.

First, the SDARS are, in the end, distributors of sound recordings and other third-party content. Although the SDARS develop some original programming that they provide around the music and other content (the so-called "wrapper"), the content itself is the essential input. Moreover, sound recordings comprise a key portion of the content, as evidenced by the amount of time subscribers spend listening to music relative to other content, and as evidenced by the reasons subscribers give for choosing to subscribe to

satellite radio.[22] Without the creative input provided by the sound recording copyright holders, these services likely would not survive in the marketplace.

Of course, the SDARS' success is driven in part by how well they program channels of music (and other content) that subscribers want to hear. However, as noted above, this incremental contribution would have zero value if there were no music content to package! The same is not true of sound recordings, which have an already established value separate and apart from their packaging and distribution *via* satellite radio. This is not to say, of course, that satellite radio does not deliver value: if it did not, there would be no subscribers.

Second, with respect to the SDARS' roles in terms of their contributions to distribution technology, I note that the concept of distributing content *via* satellite is well-established, and hence, in some respect, the innovative aspect of the SDARS is best seen as an extension of a known distribution mode to music (and other content). Obviously, the SDARS have incurred risks associated with the "launch" of the service, including the launch of the satellites and the marketing expenditures undertaken at a time when the success of satellite radio was not assured.[23] Accordingly, the SDARS should be compensated for these costs and risks, as well as for all the costs they incur on a recurring basis to deliver programming to subscribers. Based on the available evidence regarding the margins that the SDARS are earning on their programming (and on the forecasts of margins that they would earn after an increase in the blanket license), one cannot reliably conclude that Court-approval of the rate requested by SoundExchange, and the increase in licensee fee payments that such approval would create for the SDARS, would, on a forward-looking basis, push the distributors to below-competitive, risk-adjusted rates of

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[22] In addition to the survey results reported by Dr. Wind, reports issued by various equity research firms highlight the critical role of music content in the SDARS' offerings. *See, e.g.*, Citigroup Warner Report, SX Ex. 103 DR, at p. 38 (Sirius reports that 80% of people who subscribe to satellite radio do so in order to receive commercial-free digital music and that greater than 70% of subscribers' time spent listening to satellite radio is devoted to music.); "Satellite Radio Survey 2005," JPMorgan North American Equity Research, February 7, 2005. SX Ex. 108 DR, at p. 3 ("Our survey shows that the key demand driver for satellite radio is commercial free music, ...").

[23] Insofar as the transponders on the launched satellites could be used for other services, the sunk costs associated with their launch would be mitigated.

return on their up-front investments and on their on-going contributions to dissemination of music content.[24] Put another way, there is no evidence of which I am aware that the SDARS would be unable to pay on a forward-looking basis the license fees generated through imposition of the proposed rate. Nor is there any evidence that such an increase in license fees paid by the SDARS would amount to an expropriation of their reasonable returns on past investments and attendant risks. And finally, there is no evidence that the increase would necessarily substantially constrict the volume of subscribers (or undermine growth).

At the same time, this factor is not a justification for compelling a rate that provides either side with some assured return on their investments. As I already explained, a rate that assures the SDARS an above-competitive, risk-adjusted return on their investments may result in inefficiencies insofar as the rate would not only reduce the record companies' revenues from their recordings to below an amount available through market transactions, but also would raise the total cost of music distribution by insulating to some degree the SDARS from the rigors of competition. Thus, regulatory efforts to ensure such a return would benefit only the investors in those technologies. Society as a whole would be worse off.

Objective 4: To Minimize Any Disruptive Impact on the Structure of the Industries Involved and on Generally Prevailing Industry Practices.

The economic implications of this policy objective are best understood as focusing on the effects of changes in the rate (or maintenance of the current rate) on both the licensors and the licensees, here the record companies and the SDARS. In addressing this factor, two issues should be considered. First, the satellite radio industry is not yet mature, and thus, its "structure" and "industry practices" are still evolving. Second, competitive forces frequently result in "disruptive impacts" on existing industries that nevertheless bring tremendous social benefits, particularly in high-tech industries. For example, introduction of the digital calculator destroyed the market for slide rules; DVD technology essentially eliminated the demand for products that are complementary to

[24] *See, e.g.*, Citigroup Warner Report, SX Ex. 103 DR, at pp. 35-39.

video tapes; MP3 players eliminated demand for Sony's WalkMan; and following its entry, Apple's iPod quickly emerged as the leading technology among portable music players. From this perspective it follows that the SDARS should not be protected from the rigors of competition (any more than they already are by the mere fact that the industry is limited to just two players) from other existing and yet-to-emerge channels of distribution.

In the same vein, and consistent with my discussion of Objective 3, it would be inefficient to use this rate proceeding to set a rate for a blanket license that would maintain the SDARS' current margins on the theory that any change in margins would be disruptive to industry operations. And it would be also inefficient to prop up an inefficient distribution technology which otherwise might not survive on its own in competition with alternative channels of music distribution.

Of course, I am not claiming that satellite radio is surviving and prospering only because of the very low rate it pays for the content that is essential to its competitive survival. Far from it: there is no evidence that higher rates that better reflect the value of music could not be built into the SDARS' business models while maintaining their chances of future success. While the fourth statutory factor calls for the minimization of disruptive impacts, that command is qualified both by its own terms ("minimization" is not the same thing as "avoidance") and by the other statutory factors with which it must be considered.

From this perspective, I therefore understand this fourth factor to promote a policy of setting a rate that minimizes disruption by avoiding *abrupt* changes in rates resulting from changes in regulatory policy. I do not, however, understand it to require freezing regulations in place or permanently setting below-market rates that would shelter the licensees indefinitely from disruptions normally engendered by the competitive process. Nor do I view the fourth factor as advocating a rate that confers upon one distribution channel a prolonged and unwarranted competitive advantage *vis-à-vis* rival channels.

In considering a rate adjustment that minimizes disruptive impacts, the Court will need to balance potential effects on each of the industries impacted by the rate.

Impact on the SDARS. Considering the rate's effect on the SDARS is relatively straightforward. I understand that SoundExchange is introducing testimony concerning the SDARS' costs and revenues, taking into account the rates SoundExchange is proposing. If, as I understand to be the case, those rates would not drive one or the other of the SDARS from the market, the proposed rate would not have any effect on the *structure* of the satellite radio industry. Moreover, there is no indication that higher rates would effectively curtail the ability of the SDARS to compete on the merits (*i.e.*, on the basis of the desirable attributes of satellite radio service) against other distribution channels and to continue to increase their subscriber base.

Impact on the Music Industry. Addressing the effect of the rate on the structure of the music industry is both less and more complicated. It is less complicated because the industry is simply asking for a higher rate which surely should improve its "bottom line." It is also more complicated inasmuch as *not* granting the rate increase could have an important impact on the industry's future. The music industry is in flux as it transitions from a principal reliance on CD sales for its revenue to an increasing reliance on multiple sources of revenue flowing from different channels of digital distribution of non-physical copies of sound recordings. That transition raises a host of issues relating to consideration of this fourth statutory factor: (i) how quickly the transition will occur; (ii) the extent to which any particular form(s) of digital distribution will gain market acceptance and become most prevalent in the future; and (iii) the extent to which the various forms of digital distribution are substitutes for each other, and for CD sales.

Taking these sets of concerns together, in considering the policy implications of the fourth factor the Court should neither protect the SDARS from the market effects of market-based pricing of access to sound recordings, nor the music industry as it increasingly relies on digital distribution of music. It should, however, scrutinize the rate to make sure that whatever the long-run effects the change in the rate is likely to have on the two industries, it does not cause immediate disruption. This may include

considerations of the different structure of the blanket license and the speed of migration to a proposed rate.[25]

In sum, the fourth factor recognizes that industry participants may need time to adjust to significant changes in the rate, given their existing market arrangements. A drastic change in a regulatory regime can disrupt the business plans of industry participants. However, this recognition should not be, in my view, a basis for inertia with respect to rates for access to sound recordings that the SDARS should pay. After all, firms in effectively competitive markets have to deal with change all the time, and those unable to adapt fall by the wayside. Here, in particular, I see no evidence that proper phasing-in of new and higher rates either would undermine the economic viability of the SDARS or would deprive the listening public of the benefits of this mode of content distribution. At the same time, sticking with unduly depressed rates for the blanket license will adversely impact the record companies (as the satellite radio subscriber base grows) and will distort competition between the SDARS and other distribution channels.

V. RATES ARISING FROM VOLUNTARY TRANSACTIONS

It should be clear from the discussion in Section IV that rates arising from voluntary transactions best satisfy in principle the policy objectives set out by the statute, and promote economic welfare that reflects the interests of listeners, record companies, copyright users, and other relevant parties. Although markets for the rights to perform recorded music do not resemble the stylized model of "perfect competition" discussed earlier, voluntary transactions between record companies and various licensees in the marketplace nonetheless provide useful guidelines for setting rates for the distribution of sound recordings by the SDARS.

[25] In this regard, the escalating nature of SoundExchange's proposed rate accounts for the fact that the SDARS, based upon forecasts, will gain additional scale efficiencies over time, and thus will be able to distribute their fixed costs over a larger volume of subscribers. In other words, while an immediate imposition of the ultimate rate might place a strain on the SDARS' ability to continue to invest in expansion of and enhancements to their services, a phased-in imposition will be less of a burden due to increased efficiencies in operations of the networks.

I declare under penalty of perjury that the foregoing testimony is true and correct to the best of my knowledge and belief.

Date: 10/30/2006

Janusz A. Ordover

Before the
COPYRIGHT ROYALTY BOARD
LIBRARY OF CONGRESS
Washington, D.C.

In the Matter of	)	
ADJUSTMENT OF RATES AND TERMS FOR PREEXISTING SUBSCRIPTION SERVICES AND SATELLITE DIGITAL AUDIO RADIO SERVICES	)	Docket No. 2006-1 CRB DSTRA

TESTIMONY OF

MICHAEL PELCOVITS

Principal, Microeconomic Consulting & Research Associates, Inc. (MiCRA)

October 2006

> To reflect the relative roles of the copyright owner and the copyright user in the product made available to the public with respect to relative creative contribution, technological contribution, capital investment, cost, risk, and contribution to the opening of new markets for creative expression and media for their communication; and
>
> To minimize any disruptive impact on the structure of the industries involved and on generally prevailing industry practices.

17 U.S.C. § 801(b). The statute offers no guidance on how to translate these policy goals into a concrete rate. Even an exhaustive consideration of each side's "technical contribution," for example, would not point the Court to a particular rate or rate structure.

Dr. Janusz Ordover is submitting testimony analyzing the statutory factors and describing how economists would effectuate these policy directives in rate-setting. I adopt Dr. Ordover's view that here, the policy objectives set out by Congress are most fully satisfied by rates that would be the likely outcome of marketplace negotiations among the individual record companies and the individual SDARS. In what follows I identify rates that would be derived in such a competitive marketplace, were it to exist. That analysis is supplemented, however, by consideration of the fourth factor, which reflects policies that may be, but are not necessarily, consistent with results from the competitive market.

As Dr. Ordover explains, the critical determinate of the market (and fair) price of sound recordings ultimately is the value those sound recordings have to the consumers who purchase them. That is one reason why the rates sound recordings obtain in free market transactions are relevant to the rates that should be set here. Rather than repeat Dr. Ordover's explanation, I offer two additional and related points, one theoretical, one practical.

I declare under penalty of perjury that the foregoing testimony is true and correct to the best of my knowledge and belief.

Date: 10/27/06

Michael Pelcovits

Before the
UNITED STATES COPYRIGHT ROYALTY JUDGES
Washington, D.C.

In the Matter of: Determination of Rates and Terms for Preexisting Subscription Services and Satellite Digital Audio Radio Services	Docket No. 2011-1 CRB PSS/Satellite II

TESTIMONY OF

JANUSZ ORDOVER

Professor of Economics and former Director of the Masters in Economics Program at New York University

Public Version

Witness for SoundExchange, Inc.

5. To develop the conclusions that are discussed in the main body of my report, I relied on my experience in assessing pricing issues generally, as well as pricing of access to content across numerous industries (such as music, motion pictures, software, and cable television), the relevant economic literature, and my knowledge of the music industry. In addition, I reviewed and analyzed data pertaining to the royalty payments made by interactive audio mobile/portable subscription streaming services ("interactive subscription services") to record labels, as well as contracts between non-statutory services and the record labels. Finally, I conducted interviews with executives at the four major record companies who are centrally involved with the licensing of sound recordings to digital music distribution services.

B. Summary of Conclusions

6. The core economic principle underlying my work in this matter is that the section 801(b)(1) statutory criteria are most consistent with the development of a royalty rate that approximates the terms that would be reached by the parties in an unfettered marketplace setting, *i.e.*, one free of the applicable compulsory licensing regime. Such a rate would reflect the value of sound recordings to Sirius XM subscribers, given the pricing and availability of other channels of distribution through which consumers are able to listen to music. It is reasonable to expect that a material portion of that value would flow to sound recording copyright holders inasmuch as music represents a critical element of satellite radio that attracts subscribers to the service.

7. I am aware of no direct evidence on what rates might be negotiated between Sirius XM and copyright holders in an arms' length setting for access to a record company's entire catalog of music for use on Sirius XM's satellite radio service. This is so because, on the one hand, Sirius XM is assured access to the music content at a statutory rate, if the negotiations were to fail, and on the other hand, the record companies do not bargain individually with Sirius XM. Consequently, it is necessary to develop an appropriate benchmark that could serve as a basis for setting the required backstop rate for Sirius XM.

I declare under penalty of perjury that the foregoing is true and correct.

Date: 11/28/2011

Janusz A. Ordover

CERTIFICATE OF SERVICE

I hereby certify that on April 8, 2015, I caused copies of the foregoing document to be served via email on the following parties, which have consented to email service:

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